3. CESEE risk outlook

3.1. CESEE RISK MATRIX

Table 3.1 / Summary of risks

Changes since last report:

› We have introduced two new risks. First, 'European Parliament election leads to big gains for anti-EU forces'. We rank this risk as high in terms of likelihood, but think that the impact will be quite low.

› Second, we introduce a new positive scenario: 'German consumption growth roars into life'. We rank this low for likelihood, but high for impact on CESEE.

		Impact on CESEE countries*		
		High	**Medium**	**Low**
Likelihood	High	Global trade war/major Chinese slowdown Smaller EU budget (only EU countries) Renewed outbreak of EZ crisis	Rule of law and quality/independence of institutions deteriorate further	European Parliament election leads to big gains for anti-EU forces
Likelihood	Medium	Labour shortages stimulate higher investment		
Likelihood	Low	Formalised core/periphery in EU (only EU countries) German consumption growth roars into life	EM crisis affects more countries in CESEE Faster-than-expected tightening by ECB Hard/no deal Brexit	Improvement in EU-Russia relations

Note: Red = negative risk, green = positive risk. *Impact on all 22 CESEE countries covered by wiiw unless otherwise stated. Risks related to the forecast period, 2019-21. When measuring likelihood, high = 30-49% chance, medium = 10-30% chance, low = 1-10% chance.

Table 3.2 / Positive risks detail

Risk	Likelihood		Impact on CESEE	
Labour shortages stimulate virtuous cycle of rising wages and investment.	Medium	Many countries in CESEE are facing acute labour shortages, including jobs requiring few skills. It remains unclear how this will go in the long-run. Foreign firms in the region, faced by less labour and higher wages, may decide to move production east. However, they have many big incentives to stay, including high sunk costs, a better business environment, proximity to Western Europe, and a higher quality of labour and infrastructure. More broadly, a lack of labour could stimulate higher investment in automation, leading to higher productivity in the services sector as well.	High	Higher investment in productivity-enhancing improvements would lift the region's growth potential, and could increase per capita real GDP growth quite significantly. This could also feasibly improve the pace of convergence.
Improved EU-Russia relationship leads to removal of sanctions and increased trade and investment flows between the two.	Low	This has become moderately more likely now because of US policy, which has resulted in closer EU ties with countries under pressure from the US such as Iran and Turkey. However, Russia remains a special case, especially because EU sanctions on it are tied so closely to Minsk II (the terms of which are almost impossible to imagine Russia meeting). Nevertheless, opinion surveys indicate significant positive sentiment towards Russia in many EU countries, including in Germany.	Low	An unwinding of Russia-EU sanctions would matter more for Russia than other countries, but it is unlikely that it would be a game changer for anyone. The reasons that the Russia economy is doing so badly are mostly either structural or because of the weaker oil price of the last few years, not the sanctions. There would be a small positive impact on Russian growth, with spill-overs for other CIS countries. For the rest of CESEE, the impact would be minimal. Most have diverted trade away from Russia since the sanctions were introduced, and would not quickly go back. Many EU investors would remain wary, especially if tensions between Russia and the US remain high.
German consumption growth roars into life	Low	The German economy has slowed significantly recently, leading to major downgrades to growth projections by many leading forecasters. Germany's high level of dependence on external trade means it has been particularly badly affected by the US-China trade war. However, many domestic indicators are positive, including in the labour market and wage growth. There remains a (fairly small) chance that Germans will shrug off negative external news, and that higher spending could trigger a virtuous cycle of rising consumption and investment.	High	This would be very positive from the perspective of CESEE. Germany is an important export market for almost every country in the region, as well as a key source of FDI, tourism and remittances for many.

Table 3.3 / Negative risks detail

Risk	Likelihood		Impact on CESEE	
Renewed outbreak of the eurozone crisis.	High	Progress on reforms of the eurozone to better insulate it from the next downturn in growth remains painfully slow. In Germany, such reforms tend to be seen as the German taxpayer subsidising profligate Southern Europeans. The government in Italy makes this an ever harder sell in Germany. Some insurance is provided by the expanded role of the ECB in recent years, but over the medium term this may not be enough on its own to prevent a new crisis.	High	The eurozone is not in great shape for the next downturn (which may already be here). In the long run it needs a banking union and some kind of fiscal sharing to be able to ward off speculative market attacks during downturns. Any break-up of the eurozone (which is highly unlikely, although no longer unthinkable with the current Italian government in particular) would badly affect the economies of CESEE, due to high levels of trade, investment and financial integration.
Global trade war involving exchange of sanctions between US and China and visible impact on global trade volumes.	High	This is already to an extent underway. Trade restrictions on imports into both the US and China have increased significantly over the past decade, and global trade relative to GDP has been flat since the crisis. However, several exchanges of sanctions between the US and China would have a significant additional impact on global growth and trade.	High	This is a key risk for growth in our region during the forecast period. Most economies in our region are very open in terms of exports/GDP, and many deliver inputs into the German supply chain that go directly to China or the US. If the US introduces higher tariffs on EU car exports, the impact would be even higher.
Rule of law and institutional quality deteriorates further in CESEE countries.	High	This is already happening to an extent. Indicators of institutional and governance quality have declined for some CESEE countries in recent years, such as Turkey, Poland and Hungary. Governments in these countries look quite well entrenched, and are popular in most cases, meaning that current trends may well continue. For the EU countries, Brussels has so far shown itself largely unable to take any action.	Medium	Governments can get away with it for a while, but as the example of Turkey shows, an undermining of institutional independence can contribute to a crisis. In the case of Poland and Hungary, there are already signs that it is affected domestic private investment. Lower quality institutions also threaten long-term growth.
EU budget is cut and EU-CEE countries receive significantly less money in the new financing period	High	A smaller post-Brexit EU budget is highly likely. Funding priorities may also change, including a linking of future EU funding to certain benchmarks. There is a growing feeling in some Western European capitals that funding should be tied more closely to indicators such as compliance with EU law.	High	EU-CEE countries receive 2-5 percentage points of GDP per year from the EU, so cuts to the budget would be important for them.
European Parliament election leads to big gains for anti-EU forces	High	Opinion polls suggest anti-EU forces will do well, and in general voters may be more inclined to vote for 'anti-system' parties in the European Parliament rather than national elections (as they perceive the consequences to be less important). In addition, in many countries the turnout is substantially lower, so smaller groups with highly motivated voters can have a big impact on the result.	Low	There are two main reasons that this is unlikely to have a big impact. First, while the share of seats taken up by anti-EU parties is likely to be quite high, their ability to function as a single, coherent bloc will be quite low. Second, the power of the European Parliament remains quite limited. Maybe the most important implication will be greater fragmentation (and therefore difficulties in passing legislation) of the parliament, following trends already well-established at the national level.

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Table 3.3 / ctd.

Risk	Likelihood		Impact on CESEE	
Rings of EU integration are formalised and most of EU-CEE left out.	Low	Irritation in some Western European capital with parts of EU-CEE has been growing for some time. This is for three main reasons: a lack of 'solidarity' on the sharing of refugees, threats to institutional independence and the rule of law, and corruption in the use of EU funds. Recent French proposals suggested 'rings' of integration, which could lead to a more formalised 'core' and 'periphery' in the EU.	High	Any formalisation of 'core' and 'periphery' could have important political and economic consequences, particularly if it affects things like Schengen. Many EU-CEE countries could end up in the outer ring.
Hard/no-deal Brexit	Low	The likelihood of some kind of deal between the EU27 and the UK remains quite high. There are major incentives on both sides to avoid a 'hard' Brexit. Moreover, the UK parliament has put in place various measures that make a 'no deal' Brexit almost impossible.	Medium	The UK and EU27 economies are heavily intertwined, and London has huge importance for eurozone finance. A breakdown of talks and 'hard' Brexit would likely have quite serious economic and political consequences. The most direct effects would be felt in Western Europe, but the strong linkages between the German economy and CESEE would provide a channel of contagion to our region as well.
Emerging markets crisis moves beyond Turkey to affect more countries in the CESEE region.	Low	So far, most countries in our region have been relatively unaffected. Countries in our region tend to be much more exposed to the euro interest rate than the dollar, and the ECB is (and will remain) at a very different point in the tightening cycle to the Fed. In addition, most countries have reduced private debt/GDP since the crisis, including in foreign currency, and generally external vulnerabilities are lower (current account deficits have mostly been cut or disappeared over the past decade). Turkey seems like a big outlier in our region.	Medium	The impact in 2018 on Turkey's currency and bond markets, and then as a follow-through on inflation and the economy, are a big warning sign to the rest of the region. However, the much lower external vulnerabilities of almost all other CESEE countries provides a lot of insulation. The most exposed are probably those which also tend to borrow in US dollars, specifically Ukraine and Kazakhstan.
Faster-than-expected monetary tightening by the ECB causes financing difficulties for countries in CESEE.	Low	The ECB has become more dovish, in line with our long-held expectations. Core inflation trends in much of the eurozone remain very weak, reflecting major slack in many labour markets. Meanwhile economic growth slowed quite in 2018, and is unlikely to pick up again soon. A significant change in inflation dynamics looks unlikely.	Medium	Most countries in CESEE are more exposed to euro interest rates rather than dollars, and as such have been relatively insulated from the recent market turmoil. If the ECB did start a fairly quick tightening cycle, this would change, and other countries in CESEE could run into trouble. However, few would find themselves in the position of Turkey under this scenario. Turkey has much bigger external imbalances and financing needs than other countries in CESEE.